Perpetual Private | Quarterly Market Update

The seeds of new long-term trends

January 2023

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The final quarter of 2022 can be viewed as one of relative calm. Having seen some dramatic moves in asset prices throughout the year, we witnessed varying degrees of counter trend, as we closed out the December quarter. In many ways, this type of price behaviour indicates that markets and investors are moving to the next phase of their adjustment to the new monetary reality.

Ultimately, this development is welcome, as it suggests a more stable landscape in the coming months. That is not to say markets will not be volatile. Inflation remains high and the fine balancing act of bringing it under control, whilst minimising the impact on economies, will consume the attention of monetary authorities. Many market participants, in an attempt to anticipate their actions, will swing short-term conditions from optimism to pessimism, and back again.

Geopolitics will continue to draw our attention though there's a good chance it will impact markets less. Absent a spill-over of the Russia-Ukraine conflict, there is even reason to hope for slightly improved relations between countries. China, in particular, has begun to soften its level of assertiveness, demoting key 'wolf warrior' diplomats and displaying a growing willingness to re-engage with key partners.

Looking forward, we do not expect inflation to disappear from the minds of market participants. More likely it will simply recede from being the dominant factor in investment decisions, to one of a few. Though it's too soon to accurately identify them, it is now that the seeds of new long-term trends are beginning to sprout. Balancing the vigilance with which to identify them, with the presence to not jump at shadows, will be the order of the day over the months ahead.

Asset class performance – December quarter

Australian equities

Australian shares enjoyed a period of strength during the final quarter of 2022. Whilst December saw indices consolidate by between 3% and 4%, the three-month performance for the S&P/ASX 300 index was +9.1%. This represents a robust outcome concluding what had been, without doubt, a tumultuous year. Though the widely anticipated 'Santa rally' was absent, the period closed out the return of the index over the year (including dividends) to a relatively respectable -1.8%.

Considering outcomes at a sectoral level, we note that all sectors enjoyed positive returns over the three months. Utilities lead the pack with a gain of 28%[1], primarily due to Brookfield's bid for Origin on the 11th November. This result stands out, as all other sector returns fell within the range of single and low double digits: Consumer Staples[2] were the laggard with a return of 1.7%, with Materials[3] the ex-Utilities 'leader' delivering a 14.7% return.

Value[4] as an investment style again outpaced Growth[5], returning 13.8% vs 5.6%. Such is the impressive outperformance of Value over the past year or so within the Australian market, Value now outpaces Growth over all major time periods out to five years, where the two indices are now neck-and-neck at 6.6% per annum.

International equities

Major international share indices, as measured in their local currencies, experienced a range of differing fortunes during the period. With China abandoning their zero-COVID policy, the Hong Kong-based Hang Seng index enjoyed the best fortunes, delivering a gain of 15%. Closely behind, were the German DAX index and French CAC 40, producing 14.9% and 12.5% respectively. Despite the persistently negative news flow from the United Kingdom, the FTSE 100 returned a respectable 8.7%. Only the tech-heavy NASDAQ index produced a negative return over the quarter, receding by 0.8%. Remarkably, whilst the NASDAQ rounded out 2022 falling 32.5% over the year, it's four-year annualised return of 13% still leads the pack.

When we take the impact of currency movements into account, the picture remains broadly the same. As the euro strengthened over the period in Australian dollar (AUD) terms, German and French shares [6] lead all others, with gains comfortably in the high teens (18.7% and 16.2% respectively). The FTSE 100 similarly benefited, as the pound sterling continued to recover following political turmoil in the middle of the year, driving AUD denominated returns up to 11%. Conversely, a weakening U.S. dollar drove NASDAQ returns lower, so that Australian investors would have experienced a 5.9% drawdown. Again, when we view this from the longer-term perspective, it is still the leading performer over four years and more.

On a global basis, the outperformance of Value was much the same as it was here in Australia, with Growth falling 0.7%, in contrast against the 8.8% gain for Value. This outperformance now extends to over two years, however the emergence of mega Tech companies continues to hold up Growth from three years and beyond.

Focusing on the performance of individual sectors, Energy enjoyed the best returns with a gain of 11.6%, closely trailed by Industrials and Materials (11.4% and 10.2% respectively). Falling 5.9%, Consumer Discretionary was the worst performer, as a rising-cost environment constrained spending behaviour.

[1] Measured by the S&P/ASX 300 Utilities (Sector) index

[2] Measured by the S&P ASX 300 Consumer Staples (Sector) index

[3] Measured by the S&P ASX 300 Materials (Sector) index

[4] Measured by the MSCI Australia Value index

[5] Measured by the MSCI Australia Growth index

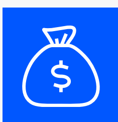
[6] Measured by the Germany DAX and France CAC 40 indexes

Real estate

Australian-listed real estate commanded a strong 11.9%[7] return over the quarter, leading its international peers. During a year when monetary headwinds dramatically impacted the valuations of income-generating assets, property endured a challenging environment. Even with a gain in the final months of the year, local REITs (Real Estate Investment Trusts) lost 12.9% [7] in value over the calendar year.

International real estate assets experienced mixed fortunes. Developed Asian markets, such as Hong Kong and Singapore held up well, gaining 7.9% [8] and 2.0%[9], respectively. This is ultimately due to regional structural considerations, as Hong Kong benefited from positive sentiment relating to Chinese re-opening. Singapore, on the other hand, has remained a relative safe harbour through recent global turmoil with its real estate assets the strongest against developed country peers across most timeframes. Europe, on the other hand, was strong into the end of the year with a gain of 8.3% in AUD terms. This, however, is a great example of the proverbial 'dead cat bounce' as, despite the gain, it still lost 36.4% in 2022. Indeed, European REITs are now at the point where they have been delivering negative annualised returns over seven years.

Of the individual REIT sub-indexes, Mortgage REITs gained an impressive 19.8% , closing the year out with a loss of 20.2%. Interestingly, despite varying performance across sectors in the final quarter of the year, when we consider performance for the 2022 calendar year, the experience was largely uniform with most sectors losing 20%-30%. From this perspective, Retail lost 'only' 7.2% in the year, as it continues to recover from its challenging experience during lockdowns, whilst Hotel & Resort gained 1.3%, reflecting the re-emergence of global travel.

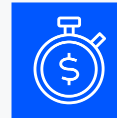


Fixed income

Consistent with the experience of many investments in the last quarter, fixed income assets reversed some of the negative price action they experienced earlier in the year. On a global basis, fixed income[10] gained 0.6% in the quarter, rounding out a 12.3% drawdown over the year. Domestically, the theme was the same but the magnitude smaller, as the Australian market has a lower duration, as well as our monetary landscape (particularly our proportion of variable mortgages) structurally requiring less monetary tightening. Indeed these characteristics allowed Australian credit markets[11] to outperform the broader local Fixed Income index[12], 1.1% to 0.4% (-6.7% to -9.7% over the year).

Alternatives

Alternative asset classes continue to prove their diversification credentials as their valuations remain somewhat independent from the turmoil of listed assets. Whilst not immune to broader macroeconomic influences, these assets tend to be more defensive in nature with managers tending to be able to exhibit a higher degree of skill in driving value enhancement, as well as being more intimately engaged with the assets they control.



Cash rate

The final quarter of 2022 saw the Reserve Bank of Australia, increase the cash target rate in each month, ending the year at 3.1%. Notably, this was at the reduced pace of 0.25% at each meeting, as the Board awaits indications of a slowing of inflation. Having increased rates by 3% in just eight months, the fastest pace in its history, the monetary environment is now significantly tighter than it was at the beginning of the year. As the impacts of this will be lagged, it is sensible to be more nuanced in the months ahead, to avoid slowing growth any more than is absolutely necessary.

Australian dollar

The Australian dollar (AUD) strengthened against the U.S. dollar over the December quarter. Having weakened by 7.3% in the prior three months, it retraced most of this coming into the end of the year, gaining 6.2%. Against the AUD, the British pound, euro and yen gained 1.3%, 2.8%, and 3.5% respectively, whilst the Chinese yuan softened by 2.9%.

[7] As measured by the FTSE EPRA Nareit Australia index
[8] As measured by the FTSE EPRA Nareit Hong Kong index
[9] As measured by the FTSE EPRA Nareit Singapore index
[10] As measured by the Bloomberg Global Aggregate index
[11] As measured by the Bloomberg AusBond Credit (0+Y) index
[12] As measured by the Bloomberg AusBond Composite (0+Y) index

Global economic overview

"There are old pilots, and there are bold pilots, but there are no old bold pilots."

Striking a new path

As we are now acutely aware, 2022 was a momentous year for investment markets, as the end of a long and (relatively) stable period came to a close. When Ben Bernanke announced that the Federal Reserve would engage in 'Quantitative Easing' (QE) on 25th November 2008, despite the fact that the strain of the Global Financial Crisis (GFC) clearly required extraordinary measures, many investors and economists feared that uncontrollable inflation would ensue. Of course, we all now know that inflation was notably absent in the years following. So much so that the Federal Reserve, along with other central banks, would return to the QE spigot time and time again.

Low interest rates, a direct result of QE, became the gift that kept giving. When it was first announced, it was deemed an 'extraordinary monetary policy'. However, as time went on and the tool was increasingly deployed, a clear lack of adverse consequences meant that it dropped the 'extra' and became simply an 'ordinary' policy - one that could be used to solve any sort of stress that economies or markets might face.

As any good statistician will tell you, the absence of evidence isn't evidence of absence. Simply put, that no consequences were observed, didn't mean that there wouldn't be any. In fairness to Mr Bernanke, the measure was ultimately successful in stabilising financial markets in the years that followed the GFC. That monetary policy became increasingly easy, driving cash target rates to all-time lows, was to the benefit of economies and likely aided in pulling millions out of poverty.

The problem is that too much of a good thing ultimately produces undesirable results. As we stand today, it is not entirely clear what the global economy will pay for years of monetary largesse. Indeed, it may turn out to be a very good deal. That we enjoyed more than a decade of economic growth and a great expansion of international trade, alongside the creation of fantastic new technologies, is nothing to be sniffed at.

As we press forward in the coming years, it's possible that we'll deem the benefit that we've received to be a good deal. That will bear itself out in the fullness of time. As we seek to respond to this new environment, we must focus on what we can glean from the data as it arises.

As it stands, the clear determination we can take from 2022 is that investment markets had become foolhardy. That so much volatility was created by rising interest rates is evidence that investors had begun to make the fatal error that 'this time is different'. That isn't to say that anyone should have expected rates to rise so quickly, the pace of rate increases has been truly historic. The issue really is that having been intentionally pushed out along the risk curve by QE, investors had begun to believe that markets could defy gravity.

As we reflect over the final quarter of the year, we see numerous examples of reaction and counter-reaction. Here in Australia the ASX 300 performed strongly, regaining much of what was lost earlier in the year, delivering returns of -1.8% for the 12 months. We were, yet again, the lucky country as some of the very things which contributed to the changed environment, namely increased commodity prices, worked to our benefit.

This though was not the experience for most asset classes or regions. Valuations of technology companies, which had become focused (and based) on years of anticipated future growth, have fallen back down to earth. That these companies had become driving components of U.S. and by extension, global indexes, meant that their retracement had a significant impact. Assets which have traditionally been deemed to be defensive in nature, particularly bonds, provided little defensive benefit (although one could easily argue that having previously delivered outsized gains, this outcome really only returns some of that excess).

Ultimately, as we have closed out last year and begun this, it has become clear that as we strive forward we will be striking a new path - something that will be meaningfully different from recent years, and something that will likely reward observers of nuance rather than the broad brushstrokes of the previous regime.

Constrained supply

That inflation was so conspicuously absent for so long, speaks to our tendencies as 'mean reversionists'. Having been a non-topic for over 10 years, it's now become the topic. Proclamations that the world might have permanently tamed inflation have turned out to be as hollow as we presumed and now, having been running below its long-run average for the better part of a decade, we now expect it to run high for a time.

As it turns out, measures to protect economies against the impacts of the global pandemic have likely been significant contributors to the inflationary environment. In normal times, such a pronounced economic shock would have caused consumers to rein in spending. In this instance, varying forms of cash payouts were injected into economies, enabling retail spending to remain high. Combine this with supply shocks driven by lockdowns and the Russian invasion of Ukraine and we find ourselves in the challenging situation we face today.

As is their mandate, central banks are obliged to address price stability. As they have little influence over the supply side of the equation, they are forced to use the blunt instrument of higher interest rates to solve for the demand side. Ultimately, reducing demand is simple but painful. Constrain the ability of households and businesses to spend by increasing their interest burden, and you're most of the way there.

The supply side on the other hand, is far more complicated. Primary sources of supply constraint are as follows:

COVID lockdowns

As governments sought to contain the spread of the virus, many borders were closed. Just as the free movement of people was constrained, so too was the movement of goods. Despite a degree of re-shoring (moving production back to domestic locations) and near-shoring (diversifying supply chains so that dependencies on any one country, such as China, are reduced), the highly interconnected state of supply chains meant that any disruption reverberates right through the production process. Albeit not as quickly as many anticipated, this component has already gone a long way towards returning to its pre-2020 state.

Commodity prices

Whilst also disrupted by effects of lockdowns, commodity prices have been most meaningfully impacted by the conflict in Ukraine. Sanctions on Russian exports, alongside an effective blockade of Ukrainian ports, led to constrained markets across the entire commodities complex. Everything from food through to energy, through to industrial metals was impacted. Here, too, we have seen some relief as commodity markets have rebalanced, with pockets of production rising to meet shortfalls.

Labour

With demand remaining strong, unemployment continues to be at, or near, all-time lows in many countries. In the U.S., for instance, one effect of the pandemic was to bring forward retirement for a meaningful portion of the workforce. In other regions, such as here in Australia, a dramatic fall in immigration had the same effect. Unlike the two pressures noted above, which have begun to resolve themselves, we expect this component to remain more 'sticky' in nature, leading labour markets to be tight for some time and holding inflation higher than it would otherwise be.

Deglobalisation

One development over recent years that is also likely to prevent inflation from returning to recent lows, is the reversing trend in globalisation. In recent times, efficient global supply chains had the effect of importing deflation across much of the developed world. Straight out of the economic textbooks, we saw specialisation in various parts of the production process bring down the cost of most end-products. With the disruptions brought about by the pandemic, the vulnerability of such arrangements has been exposed. Combine this with the complications brought about by a more tense geopolitical environment, and it is clear that there will be a reduction of globalisation. This places a long-term floor under production costs and therefore, hold price levels higher.

What we know

A key feature of the investment landscape as it stands today, is a general lack of consensus. When we consider the stated outlook from investors across all asset classes, there is a large variation of views. In our investigations we have seen views that expect inflation to remain high, we have also seen views that inflation will fall. We've even seen one instance of an expectation of outright deflation.

We also see, unsurprisingly due to the close relationship with inflation, similar variation in the outlook for interest rates, with expectations of continued increases, stabilisation and indeed, cuts. These effects span across most key fundamental data points, ultimately telling us that there remains a great deal of uncertainty around how 2023 will play out.

This is not in itself a problem. As investors we are accustomed to making decisions under such conditions. Experience tells us to focus on the details that we have some confidence in and discount for the risks we can't anticipate. For us, those details are:

Volatility to remain

Volatility in markets is a direct consequence of uncertainty. As such, we expect markets to continue to gyrate, by a not insignificant degree, as investors adjust for macro and microeconomic developments. Whilst this can be unpleasant as we see the value of our assets fluctuate, viewed through the right lens, it provides opportunities - opportunities to sell at higher prices during upswings, and opportunities to buy at attractive levels during downswings.

Growth to trend lower

With monetary authorities actively seeking to reduce aggregate demand, it is almost certain that growth will continue to drift lower. In his comments regarding their monetary policy decision in December, the RBA's governor Phillip Lowe stated, "growth is expected to moderate over the year ahead as the global economy slows, the bounce-back in spending on services runs its course, and growth in household consumption slows due to tighter financial conditions"[13]. We find similar expectations in comments made early this year from the International Monetary Fund's (IMF) Managing Director, Kristalina Georgieva. Referring to their soon-to-be released "World Economic Outlook", she notes "the numbers are still being worked out. But the headline messages are growth continues to slow down in 2023"[14].

Interest rates to remain higher than in recent years

Whilst we may already be at or near the top of the interest rate cycle, we are relatively confident that we will not see substantial cuts in the immediate future. Whilst we see reason to believe that inflation will subside from its current levels, features mentioned above such as labour market tightness and deglobalisation are likely to hold inflation above target levels for some time. Factoring this into valuation models suggests that assets with near-term earnings and pricing power will be preferable to those with long-term growth potential. That this might be the case has already seen some degree of validation, as Value has meaningfully outperformed Growth for most of the past year.

Geopolitics will continue to be strained

With the Russia-Ukraine situation continuing, an assertive China, Iranian crackdown, sabre-rattling North Korea, to name but a few, geopolitics will be an important consideration for investors. Fortunately, such things do not tend to impact markets directly and as so, remain low-probability concerns.

Pressing forward

For most of 2022, inflation has been the dominant driver of markets. Though we believe that it's importance will recede moving forward, it is unlikely to go away. More likely, it will become just one of a number of key considerations on which we must focus.

2023 will be an environment where it will be important for us to know when to act, and when not to act. As each new datapoint becomes available, many market participants will attempt to anticipate and over-extrapolate market developments. In many cases, they will be wrong and nascent trends will reverse before they become truly established.

As alluded to by our opening quote, we do not believe that conditions are suitable for taking bold actions. Instead, this will be an environment where steady, cool-headed investment decisions will be the most prudent and enable us to avoid being whipsawed.

It is certain that markets will provide much opportunity this year. Where we are able to look through the noise, through bouts of both over- and under-confidence, always bearing in mind our long-term strategic goals, we will be giving ourselves every chance to enjoy the optimal balance of risk and reward in the years that come.

[13] Statement by Philip Lowe, Governor: Monetary Policy Decision, 6th December 2022.

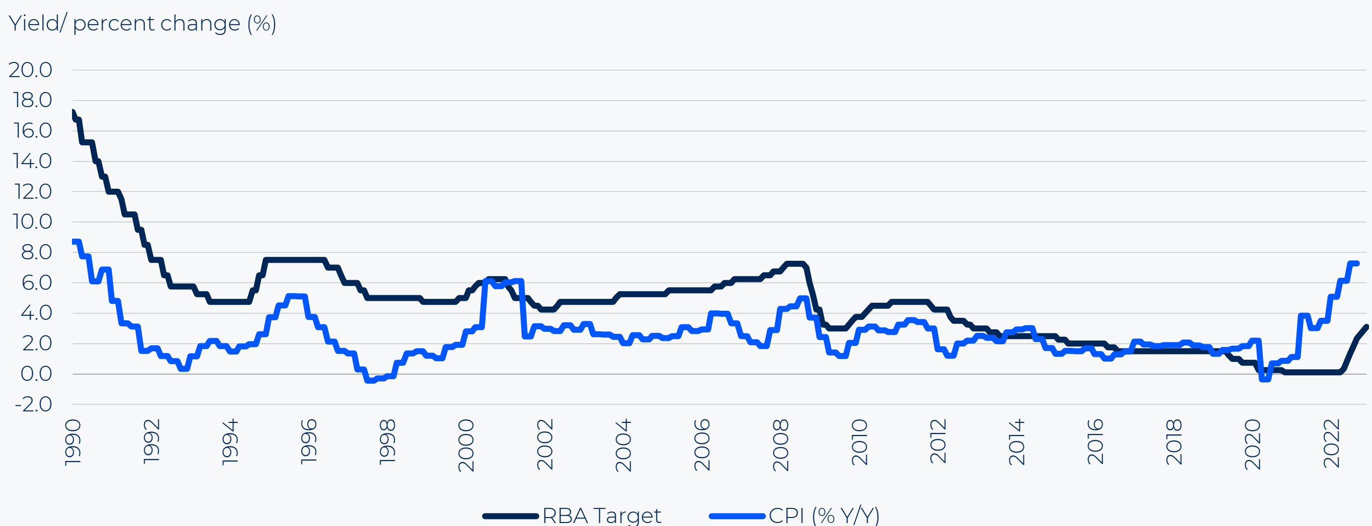
[14] Transcript of International Monetary Fund Managing Director Kristalina Georgieva Media Roundtable, 12th January 2023.

Australian cash rate and dollar

Australian cash rate

Having increased interest rates eight times over consecutive months in 2022, it is a fair assumption that we are at, or near, a peak in the cash rate target. Having clearly decided to go hard and go early in raising rates to tame inflation, the RBA increased rates by 0.5% increments in every month between June and September, before reducing the pace to 0.25% in the final three months of the year. Given the lagged impacts of monetary policy, we see good reason to expect further slowing or even a pause, whilst waiting for indications of price stability increasing. Taken from the Monetary Policy Decision statement by RBA Governor, Phillip Lowe, in December, “The size and timing of future interest rate increases will continue to be determined by the incoming data and the Board’s assessment of the outlook for inflation and the labour market”[15].

Figure 1: Australian long-term cash rate vs inflation



Source: FactSet, Perpetual Private.

[15] Statement by Philip Lowe, Governor: Monetary Policy Decision, Reserve Bank of Australia, 6th December 2022.

Australian dollar

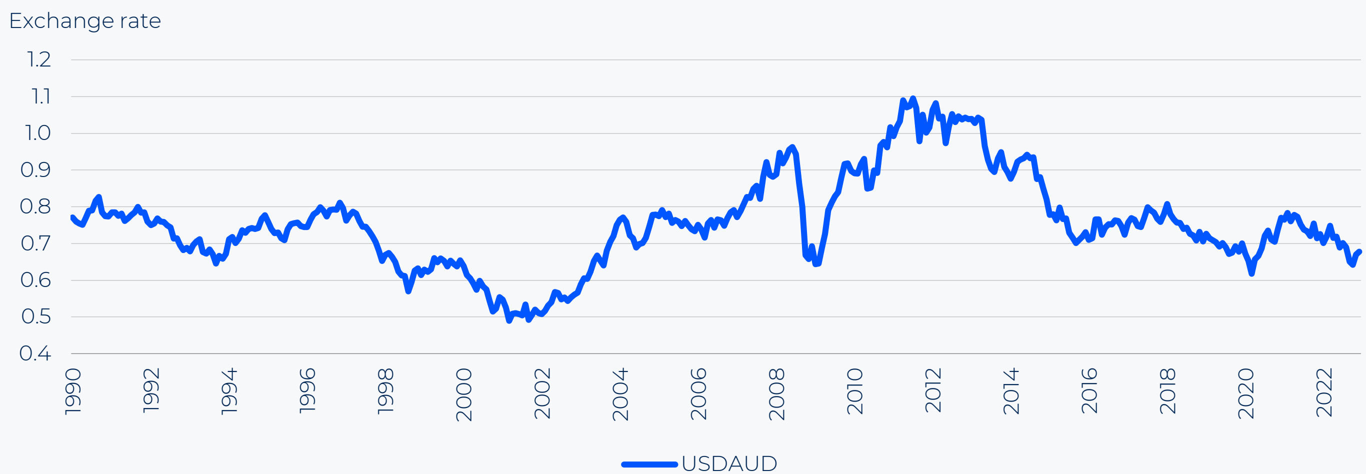
With the U.S. dollar (USD) benefiting from its 'safe haven' status, along with the Federal Reserve's comparatively aggressive interest rate increases, the Australian dollar (AUD) spent much of 2022 weakening in USD terms. Indeed this was the case for most currency pairs globally. The December quarter however saw some retracement in this trend, as the AUD/USD exchange rate increased by 6.2% to 68 cents. When we reflect on other major currencies such as the British pound or the euro, relative strength against USD is a common theme.

Having benefited from commodity exports throughout the year, the AUD softened against both the British pound (1.6%) and euro (2.8%) in the closing months. As a reflection of thawing relations with China, and the implied increase in trade, against the yuan we saw a 2.9% appreciation.

Australian dollar outlook

There is much uncertainty within and across economies as the world adjusts to the new reality in which we find ourselves. Given the expected reduction of central bank activity in coming months, it is likely that currency moves will also dampen. As our dollar has begun to strengthen against the USD and currently sits below its long-term average, the expectation is that it will be biased to the upside, absent of any systemic shocks.

Figure 2: Australian dollar-U.S. dollar daily long-term exchange rate



Source: FactSet, Perpetual Private.

Australian and international equities

Australian equities

It was a stronger December quarter for Australian equities, with the S&P/ASX 300 index increasing by 9.1% over the period. Australian equities outperformed global equities, with the MSCI All Country World Index (ACWI) by comparison increasing by 7.4% in local currency terms (4.1% in AUD terms) over the same period.

Despite broader concerns around the economic outlook globally and future corporate earnings, there were some indicators over the quarter that inflation levels may have peaked, which could theoretically allow central banks to slow the pace and size of further interest rates hikes at some stage in the near future. This saw the equity market recover strongly over the quarter from the lows of early October.

Value stocks were the clear winners this quarter (+13.8%), considerably outperforming Growth stocks (+5.6%). This shift towards Value stocks reflects a degree of risk aversion from investors against the backdrop of higher rates and sustained inflationary pressures, which also saw large cap stocks outperform small cap stocks. All sectors were positive over the quarter. The best performer was the Utilities sector (+28%), closely followed by Materials (+14.7%), A-REITs (+11.6%) and Financials (+10.8%). Albeit still positive, the weakest sectors were Consumer Staples (+1.7%), Information Technology (+1.9%) and Healthcare (+2.0%).

Figure 3: Australian shares – large companies

Source: FactSet , Perpetual Private.

Australian equities outlook

We expect movements in the Australian equity market will continue to be influenced primarily by inflation data and forecasts, as well as the path and pace of interest rates both domestically and abroad. The market will continue to pay close attention to rhetoric from the RBA and central banks globally, as investors look for indications from central banks as to whether interest rate hikes are taming inflation, which should dictate future rate hikes.

Although valuations on many stocks have adjusted lower, we believe there are still risks surrounding the outlook for certain sectors of the market. It is our view that the 'real economy' is facing the combined pressure of inflation and rising interest rates, which together will weigh on consumer spending and should become more pronounced as consumers roll off fixed rate mortgages and are faced with substantially higher minimum repayments. In particular, the downward pressure on corporate earnings from higher interest rates and a slowing economy is still to play out. Companies with elevated debt levels are particularly vulnerable, which stresses the importance of investing with managers who have a strong focus on balance sheet strength.

We expect volatility to continue and with the upcoming earnings season upon us, this should present bottom-up fundamental active managers with opportunities to deploy capital to quality and possibly oversold companies at more attractive valuations.

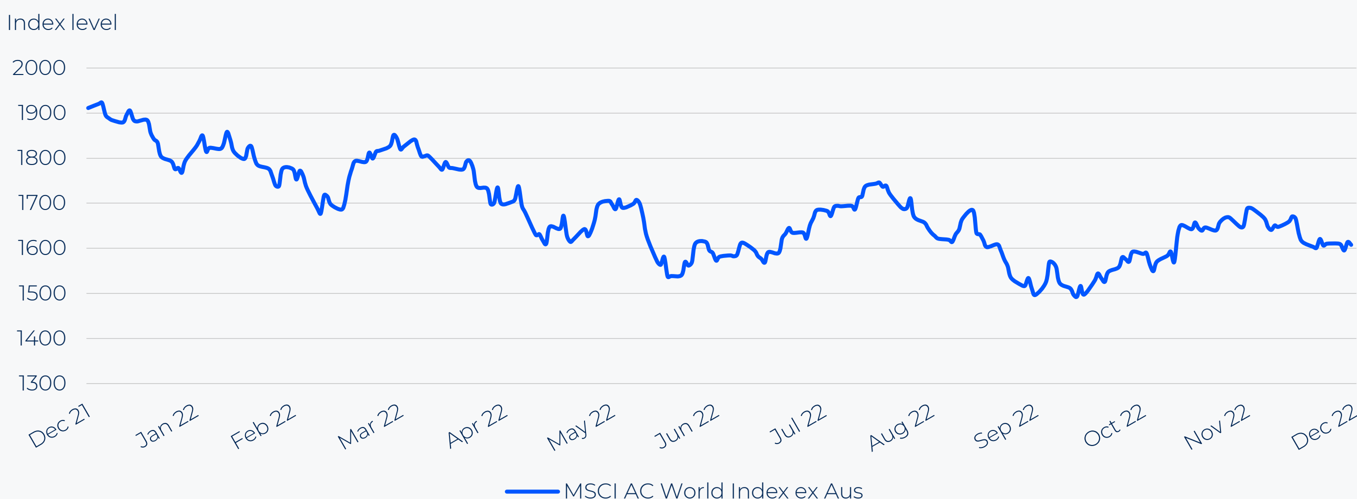
International equities

Following what was a challenging September quarter, global equites bounced back strongly over the recent December quarter with the MSCI ACWI increasing by 7.4% in local currency terms (4.1% in AUD terms).

Against the backdrop of higher rates and sustained inflationary pressures, we saw considerable outperformance from Value stocks (+12.4%) versus Growth stocks (+2.5%), and Emerging Markets underperforming Developed Markets. The strongest performer on a regional basis were Chinese stocks, with the relaxation of their zero-COVID policy adding fuel to the Hang Seng (Hong Kong) Index, which increased by 15% in local currency terms. European equities also advanced strongly over the period, most notably Germany with the DAX increasing by 14.9% in local currency terms. The biggest detractor to returns came from U.S. Technology stocks, with the NASDAQ down close to 1% over the quarter, but notably down nearly 9% in December alone.

In local currency terms, aside from Consumer Discretionary stocks which were down 3.1%, all other sectors finished the quarter in positive return territory. The strongest performer was the Energy sector (+15.4%), closely followed by Industrials (+13.7%), Materials (+12.1%), Financials (+11.6%) and Healthcare (+10.9%). Other weaker performing sectors were Communication Services (+0.7%) and the Technology and REITs sectors (both increasing by 4%).

Figure 4: International shares (local currency terms)



Source: FactSet , Perpetual Private.

International equities outlook

Equity markets continue to be driven by macroeconomic forces – specifically inflation data and forecasts, as well as the path and pace of interest rates. While uncertainty remains around the outlook for economies globally, we expect volatility to continue. Geopolitical events are hard to predict, as we've seen with the Russia-Ukraine war, whilst the possibility of a U.S. recession and a messy re-opening of China are further risks that investors must grapple with. Our main areas of focus include:

Central banks and the path and pace of interest rates

Investors are acutely focused on the rhetoric from central banks with regards to proposed and future rate hikes needed to stem inflation. As we saw over the December quarter, there were some indications that inflation levels have peaked, which subsequently led to a strong recovery in equity markets on the presumption that central banks are successfully taming inflation and could therefore slow the pace and size of further rate hikes in the near future. That said, any further tightening through higher rates is likely to limit the upside for equities as markets begin to reassess appropriate forward-looking valuations.

The earnings outlook for corporates

Earnings expectations have declined amid weakening business conditions. It is our view that the 'real economy' is facing cost constraints which together will likely weigh on consumer spending, and subsequently future corporate earnings.

We expect the macroeconomic outlook to continue driving equity markets over the near term. Leaning into companies with strong fundamentals and avoiding those with high debt levels for whom higher interest rates will increasingly prove to be a burden, is what appeals most to us in the current environment.

A-REITs and G-REITs
(listed property securities)

Following several quarters of decline against the backdrop of continued rising rates, real estate markets have rallied back over the December quarter. It was a much stronger quarter for Australian Real Estate Investment Trusts (A-REITs), with the S&P/ASX 300 A-REIT sector up 11.6% over this period. By comparison, Global Real Estate Investment Trusts (G-REITs) as measured by the FTSE EPRA/NAREIT Developed Index were up 1.3% in AUD terms.

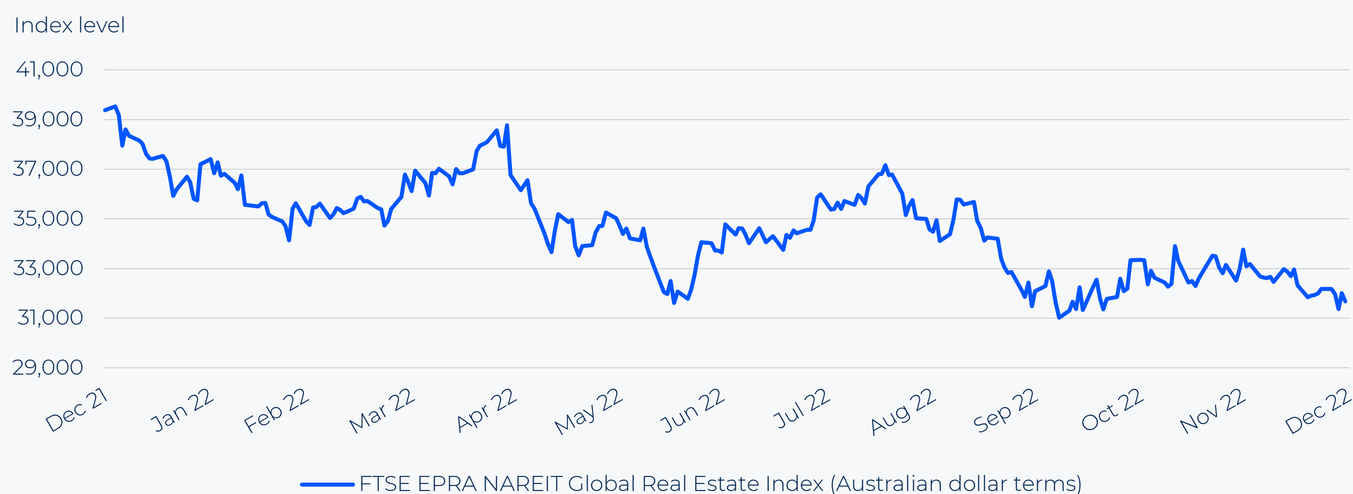
With valuation metrics closely tied to the level of interest rates and subsequent bond yields, the returns on domestic and global REITs over the quarter fluctuated closely with the changes in inflation indicators, interest rate movements and rhetoric from central banks as to the pace and path of future interest rate hikes. October and November were stronger months for both A-REITs and G-REITs, with better-than-expected inflation data and some more dovish remarks from the RBA and other central banks about the possible slowing of the pace of rate rises, leading bond yields to fall. December was a tougher month for REITs, as central banks continued to increase rates in response to persistently high inflation.

Retail was the strongest performing sector over the quarter, supported by strong tenant demand, robust consumer spending, and better-than-expected sales numbers. Sectors that were lagging over the quarter were Residential REITs and the Hotels sector, attributed to a slowdown in demand from weaker business and leisure travel.

Figure 5: Australian Real Estate Investment Trusts (A-REITs)

Source: FactSet , Perpetual Private.

Figure 6: Global Real Estate Investment Trusts (G-REITs)



Source: FactSet , Perpetual Private.

REITs outlook

Both domestic and global REITs should continue to experience heightened volatility, as underlying asset valuations are impacted by bond yields – a function of higher inflation, and subsequently, higher interest rates. With central banks adding further rate hikes over the quarter, this also continues to have an impact on the cost of debt for refinancing and acquisitions.

Those REITs with near-term debt expiry are likely to face higher ongoing servicing costs resulting in a drag on earnings. We expect those securities with more highly leveraged capital structures, and poor interest coverage ratios to underperform. Sector and geographic allocation also remain important with valuations and growth prospects differing across markets and segments.

The outlook for REITs varies meaningfully by sector and investors should be circumspect on the robustness of short-term earnings underpinning current sector level valuations and the valuations ascribed to individual assets. We remain of the view that 'quality' real estate with access to capital markets remain the most attractive investments.

Despite the short-term volatility in markets and a steep share price decline in REITs over these past 12 months, valuations are now at multi-year lows and we are starting to see more attractive investment opportunities emerge with a number of REITs now trading at considerable discounts to fair value.

Fixed income

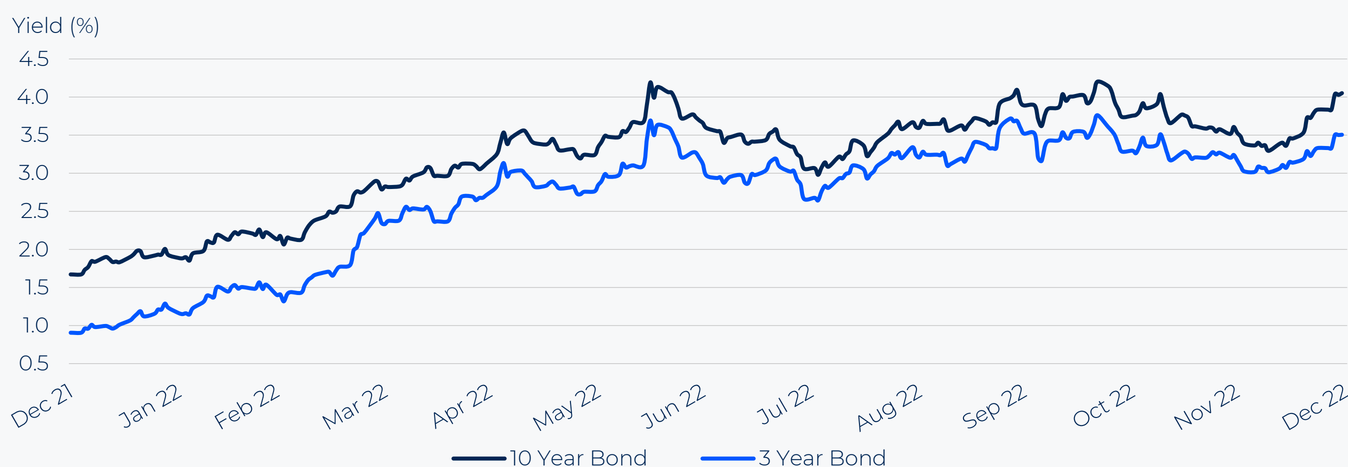
In the domestic bond market, the Bloomberg AusBond Composite Index returned 0.38% during the December 2022 quarter. The Australian yield curve was volatile over the quarter rising initially and then falling slightly, as markets digested new inflation readings and comments by the Reserve Bank. At the end of December, the Australian 10-year bond yield was 4.05%, having risen by 0.15% since the previous quarter end.

In response to inflationary pressures, the RBA has embarked on its most aggressive policy tightening for decades after keeping rates at historical lows during the COVID pandemic. Over the recent quarter, the RBA increased the cash rate target multiple times from 2.35% to 3.1% at the end of December 2022. In the RBA's most recent statement, they indicated that while cash rates, higher inflation and higher interest rates are putting pressure on household budgets, domestic demand remains resilient.

On the global front, the Bloomberg Barclays Global Aggregate Bond Index (Hedged) returned 0.64%. Credit marginally outperformed the general market, with the ICE Bank of America Global Corporate Index (Hedged) returning 0.92% over the quarter. High Yield debt, as measured by the Bloomberg Global High Yield Index (Hedged), rallied strongly, returning 6.0% for the period.

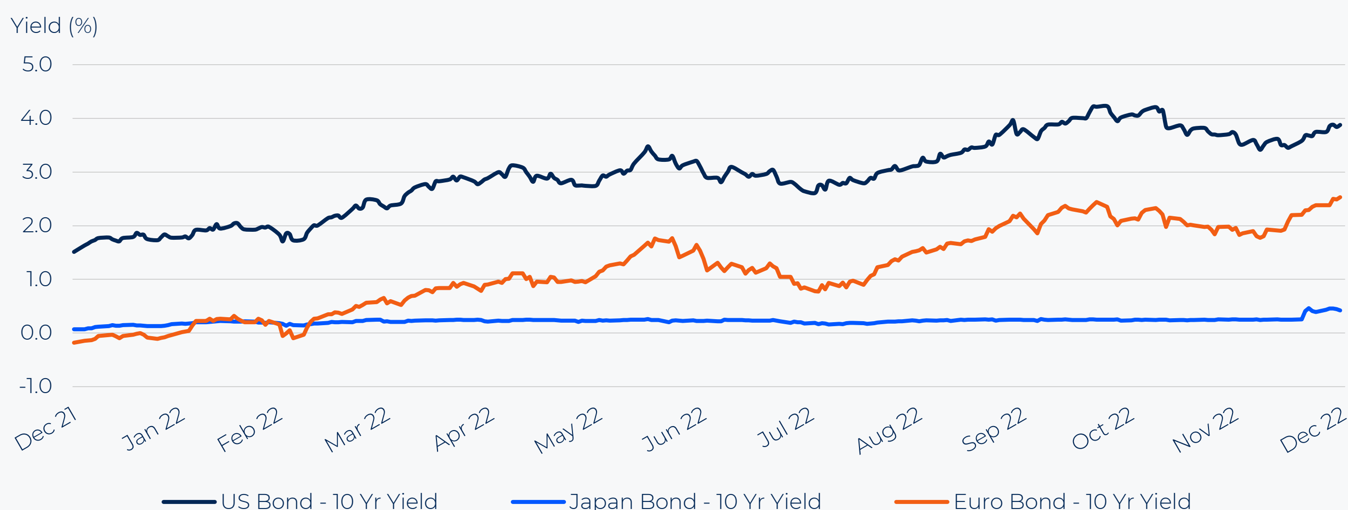
AUD strengthened relative to the USD while the U.S. 10-year yield rose from 3.79% to 3.88% over the quarter. The U.S. Federal Reserve has continued tightening policy rates since March 2022. At its December meeting, the Federal Reserve increased rates by 50 basis points, bringing their target range to 4.25%-4.5%.

Figure 7: Australian government bonds



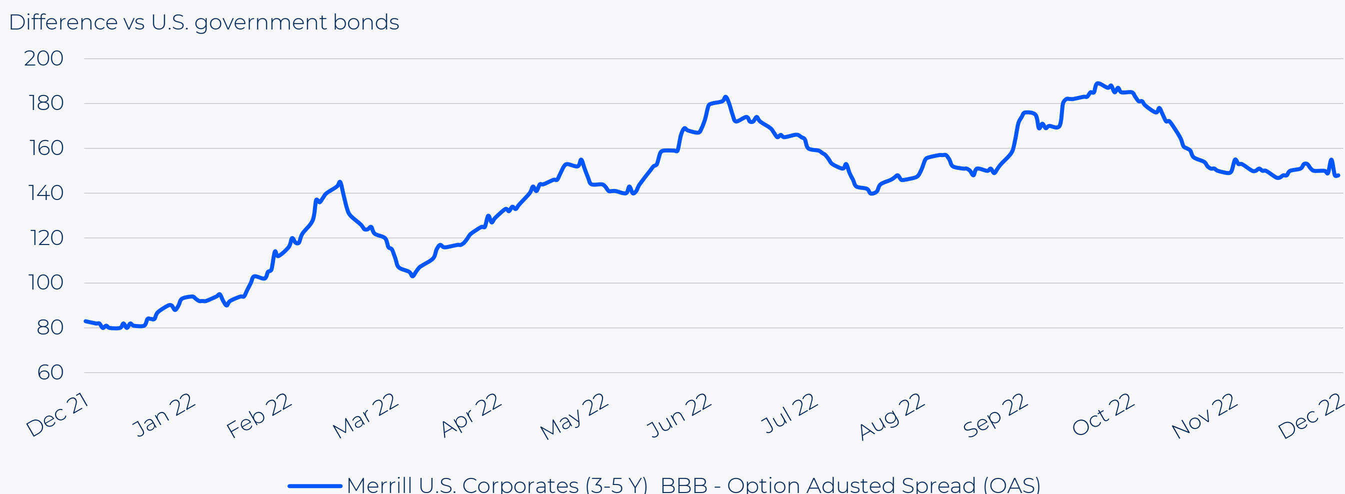
Source: FactSet, Perpetual Private.
Note: Bond prices are inversely correlated with bond yields.

Figure 8: Global government bonds



Source: FactSet, Perpetual Private.
Note: Bond prices are inversely correlated with bond yields.

Figure 9: Global credit markets



Source: FactSet, Perpetual Private.
Note: Bond prices are inversely correlated with bond yields.

Fixed income outlook

We are becoming increasingly constructive on duration, with a view to being in line with market benchmarks and acknowledging that we are likely closer to the end of the rate hiking cycle than the start. While we believe rates could rise higher in the interim, we have seen some moderation to headline inflation, as well as a number of concurrent economic indicators. Tight labour markets continue to support consumer demand but any softening to this metric will likely be dependent on a mix of future labour demand and mobility factors.

Bond yields have risen substantially over the year, and on a historical valuations basis, look cheap when compared to the previous five years. We do retain some caution, stemming from the fact the inflationary environment, and more importantly the central banking reaction function to headline inflation, remains broadly uncertain. Whilst long-term inflation expectations remain well anchored around 2.5%, we note that the shorter-term inflation expectations vary materially across the market. This divergence in views is consistent with the intra-quarter volatility observed over the December 2022 quarter.

Higher cost-of-debt have also weighed on credit valuations as markets priced in an increased probability of default. However, we note that the initial adverse reaction to rising debt costs and increased defaults has given way to a more benign view of default probabilities, and we have seen credit spreads tighten. Credit as an asset class remains susceptible to higher terminal interest rates and thus, we continue to exercise caution when investing.

Alternatives

Growth alternatives

Despite continued market volatility in listed and tradable markets during Q4 2022, private markets continued to carry on with little fanfare. Transaction volumes across all asset classes (Private Equity, Real Estate and Infrastructure) softened further in Q4 2022 due to lack of market clarity and uncertainty around the cost of debt (as the path of interest rates became less clear). Despite the drawdown in equity markets, valuations across Real Estate and Infrastructure are broadly unchanged (short of any company-specific issues coming to the fore). We expect to see some valuation weakness within Private Equity, and specifically, Venture Capital.

Demand for Infrastructure remains strong, with institutional investors placing a premium on consistent and stable cash flows, and more recently, their 'inflation hedging' properties. The regulated assets are positioned well to deliver returns through the current inflationary environment with the ability to pass inflation-linked cashflows through to investors. A number of the energy transmission assets are well-positioned to benefit from the 'energy transition' as renewables connect into the grid. Despite higher long bond rates, many private assets appear to be well insulated, with most external valuations carried out on a 'through the cycle' basis resulting in limited movements in valuation assumptions.

Within Private Equity (PE), Leveraged Buy Out (LBO) transaction volumes have slowed, reducing the pace of deployment and realisations in Q4. We expect further moderation through 2023 as a result of a clear shift upwards in borrowing costs, uncertainty around the ability of companies to pass through inflation and general macroeconomic doubt. Holding values are also beginning to retreat, with the largest expected pockets of weakness likely to be in Venture Capital (VC) and large cap LBO. Despite the changing market dynamics, we remain steadfast in our approach to PE, giving credence to acquisition valuation multiples, costs of debt and the manager's operational capability. We are optimistic that 2023 will be a fruitful investing environment.

Sector and geographical dispersion have increased within Real Estate markets. The most notable dynamic over the past quarter is the anticipation that U.S. multi-family rental growth rates will begin to soften and depending on the unemployment outlook (among other things), may even fall. Domestically, the cost of debt combined with the uncertainty about the outlook for rental growth has stymied several transactions. Our focus remains on the nexus between availability of capital and valuations. Of note, we are seeing the cost of debt rise in the U.S., which is slowing transaction volumes and dampening prices. Finally, we have seen cap rates begin to widen in the Industrial sector, an area in which we were already circumspect.

Changing market dynamics (inflation, path and pace of interest rates, weakening economic environment) warrants continued reassessment of our thinking and outlook. For now, our focus remains on central bank policy decisions, and on the health of the 'real economy'. We are responding to what we expect a market environment more akin to that of the environment prior to the GFC (interest rate cycles, and greater focus on fundamentals) by adding hedge fund strategies with a focus on security selection within equities and credit. Where we make commitments to Private Equity, we are particularly focused on operational capability (as opposed to balance sheet optimisation).

Income alternatives

High Yield printed a positive return for the quarter due to a combination of higher yields and spread tightening activity. The Bloomberg Global High Yield Index posted a 6% return for the period but a -12.6% return for the year, reflecting an extremely volatile period in this asset class. We favour instead Leveraged Loans, which by comparison have not experienced the same level of volatility as High Yield, whilst continuing to outperform on a relative basis year-to-date.

We expect most private debt to have lower marked-to-market impact because of the higher comparable spreads in a broadly syndicated market. CLO equity has been an area of strength during a period of volatility in credit and has done well over the year.

Going forward, we expect an increased number of downgrades by ratings agencies and the possibility of higher defaults will weigh on High Yield, Syndicated Loans, CLO and private debt valuations over the next six to twelve months.

Over time, we expect to move our focus from 1st lien unlevered private debt, to favour more liquid securities diversified across multiple credit sectors. We find this change to be appealing as it has better liquidity characteristics as well as producing a more attractive income stream. Areas which are beginning to provide appealing investment cases include Convertibles, Investment Grade structured product, High Yield and more broadly, Syndicated Loans.

Additionally, we are monitoring conditions so that we may be well positioned to take advantage of any market repricing, should Private Corporate Debt become attractive as the year progresses.

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Investment Director, Perpetual Private

Andrew Garrett provides investment research, portfolio construction and bespoke investment advice for Perpetual Private's clients. He works closely with advisers by providing specialist investment knowledge on Perpetual's investment process and strategy implementation, focusing on delivering optimal solutions to our stakeholders and partners. This is further augmented by his provision of transparent and accessible knowledge of financial markets and asset classes both globally and locally. Andrew is a holder of the Chartered Alternative Investment Analyst and the Chartered Financial Analyst designations.

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